

# ESCAPING MEDIOCRITY: TURKEY AT AN ECONOMIC & POLITICAL JUNCTURE

*In the aftermath of the failed coup attempt on 15 July 2016, Turkey stands at a critical political and economic crossroads. In this article, the author explains that political risks, including increasing polarization and the endangerment of democratic principles, are exacerbating weaknesses and undermining Turkey's long-term economic prospects. In particular, the Turkish economy is suffering from its dependence on foreign funds, unemployment, inflation, and a decline in administrative capacity. In order to set Turkey back on its course, a new political and economic paradigm is required. This should include an institutional overhaul with regards to democracy and the rule of law; reforming education and technology in order to address Turkey's middle-income trap; eliminating welfare inequalities; and implementing a sustainability agenda.*

Selin Sayek Böke\*



TURKISH POLICY  
QUARTERLY

Summer 2016

\* Selin Sayek Böke is the Republican People's Party's (CHP) spokesperson and vice chair responsible for Economic Policy.

**T**urkey has incredible economic potential arising from two primary sources – its young population and its geographical location.

Turkey will continue to be a young country until 2035, with demographics dominated by its young population. This not only creates significant domestic market potential but also prospects for an extensive base of human capital if properly harnessed and developed. However, the youth are currently unable to find means of contributing to the generation of sustainable dynamism so desperately needed in the country. One out of every three youth in Turkey is not in education, employment, or training (NEET). This is a tragedy and a major waste of talent for the country as a whole. Turkey stands at a demographic turning point. Either it will invest in its youth and develop its economic potential, or it will lose its young people and this demographic window will shut down.



Turkey also is located at a geographic crossroads. A bridge between Europe and Asia, Turkey is a key player in the geopolitics of the region. While the geopolitics of the region may sometimes be classified as a risk factor, the ability to reach 1.5 billion people and a market of 21.6 trillion dollars across 58 countries within a 4.5-hour flight zone is a great logistical advantage. Turkey's geographical location creates both risks and great economic potential.

Turkey is not only at a demographic and geographic juncture, more critically it faces a political and economic one as well. This pressure for Turkey to make a decision regarding which path it is going to take at this economic and political turning point has been building for quite some time now. However, following the failed coup on 15 July 2016, there is an urgent need for a political reset that will strengthen democracy, and for a shift to a new economic paradigm. Once again, Turkey faces a critical choice. We will either seize the opportunity presented by this horrible attempt to overthrow our democracy and build up an inclusive state and social framework that will be the building block of a true democracy, or we are doomed to mediocrity in every sense. In other words, we will either start doing things differently, or continue the habits of the last 14 years and fall short of our potential.

These habits have created political and economic vulnerabilities, and most importantly social vulnerabilities that have encouraged non-democratic pressure to build against the much-needed democracy. Continuing on this path will only deepen Turkey's problems and stymie its development and ranking in the world.

### *A Political Crossroads*

Political risks are on the rise. These are not only the risks created by government policies that generate uncertainties in the financial and economic operations of companies or instability due to the geopolitical situation. These political risks in Turkey are now much more encompassing and therefore much more threatening. Turkey has been polarized through exceedingly divisive political language and a political governing structure. This polarization is not only a political risk, but has also become a very critical social one. While this polarization was evident in the political language prior to the coup attempt on July 15th, it has since then crystalized into a state of emergency issued by the government.

*“Following the failed coup on 15 July 2016, there is an urgent need for a political reset that will strengthen democracy, and for a shift to a new economic paradigm.”*

A recent survey conducted by Bilgi University in Istanbul with the support of the German Marshall Fund (GMF) clearly shows the very critical nature of these politically-driven social risks.<sup>1</sup> Roughly three out of every four respondents do not want anything to do with people who have voted for parties they feel distant from, whether it be as neighbors, in business, or having their kids play or marry. In all cases, the source of polarization is not peoples' voting preferences; it is politics. It is not the nature of society but rather politics that has polarized society. This polarization suggests political ghettos, segregated neighborhoods scattered throughout Turkey. It suggests social diversity being replaced with distance, where distance is defined by political preference. It suggests these distances will spill over into the future as children are forced to learn about the world through the lenses of their family's political preferences.

The very polarized nature of our society is driven by politics and can only be resolved through a change in politics. Turkey stands at a political crossroads. Either it will continue with its polarizing politics and continue to undermine freedoms, the rule of law, and democracy, or it will rewrite a truly inclusive social contract.

<sup>1</sup> “Türkiye’de Kutuplaşmanın Boyutları,” [The Extent of Polarization in Turkey] Bilgi University, Istanbul, 2016.

### *An Economic Crossroads*

We are at the same crossroads in the Turkish economy as well. Indeed, the social risk of extreme polarization, through its erosive effect on institutional quality, has important implications for the economy. Politically-driven social polarization leads to a lack of equal opportunity, where both resources and job posts are distributed based on political loyalties and affiliation rather than merit. In fact, over the years, despite our very public warnings, through an intentional planting of “F-type” individuals – people affiliated with the Gülenist movement – the government has decimated the bureaucracy. Favoritism in the distribution of jobs and resources is possible only with a strong disregard for the rule of law. Two institutional factors – disregard for the rule of law, and a loyalty-driven public administration – have been the backbone of the crony-capitalist system established by the Justice and Development Party (AKP). This economy is best defined as a consumption-driven, construction-based economy. It has reached its structural limits, resulting in several economic vulnerabilities.

*“Two institutional factors – disregard for the rule of law, and a loyalty-driven public administration – have been the backbone of the crony-capitalist system established by the AKP.”*

These vulnerabilities are evident in the macroeconomic outcomes. Turkey’s growth rate has plummeted from an annual average of 4.9 percent from 1923-2011, to an annual average of 3.3 percent in the last four years. Not only is the growth rate lower, but it is also unsustainable and exclusive. Official unemployment has been around 10 percent for around a decade, but rises to around 18 percent when discouraged individuals are also included.

Inflation has stubbornly remained above the target set by the authorities and is very high by international standards. Sadly, but understandably, inflation is not the only unmet economic target; many of the economic targets set out in the Medium-Term Framework have not been achieved. The decline in administrative capacity explained above has been a significant contributing factor to this phenomenon. This goes hand-in-hand with the lack of governmental focus on the economy. The government’s failure to formulate a comprehensive economic policy framework has led to an unbalanced basket of policy tools, where monetary policy was given a disproportionate amount of influence compared to fiscal policy and other regulatory policies. The government interpreted fiscal policy solely as a benchmark

for discretionary spending and resource distribution rather than as a policy tool to achieve sustainable, equitable, and inclusive growth. This meant a lonely Central Bank in the policy limelight, expected to resolve all of the structural problems of the Turkish economy. For quite some time now, economic policy in Turkey has been purely discussed through the Central Bank and interest rates, and in fact only in terms of lowering interest rates. This abuse of fiscal and monetary policies and the lack of a coherent economic policy framework have contributed to higher risk premiums and in turn higher interest rates. A change in the policy framework would lead to a natural decline in interest rates.

Take for example our international transactions. Despite a drop due to lower oil prices, the high current account deficit in Turkey remains a significant economic vulnerability. As of the end of 2015, the current account deficit as a share of gross domestic product (GDP) remains as high as 4.5 percent. This level is both historically and international-

*“The high current account deficit in Turkey remains a significant economic vulnerability.”*

ly high. The mirror image of this vulnerability is the low levels of domestic savings. More worrisome is the fact that the current account deficit is not due to an intensive private investment effort that is made possible by a climate conducive to investment. Despite the low levels of investment, a savings level that is even below this investment level is the result of a steady current account deficit.

At the end of the 14-year AKP economic model, one of the most critical structural problems of the Turkish economy is its heavy dependence on foreign funds, which leaves Turkey at the mercy of global business cycle conditions. The extensive global liquidity in the past eight years provided the Turkish government with a great opportunity in the form of ample funds that could have financed country’s much-needed structural reforms and made it possible to implement a productivity-enhancing fiscal policy. This opportunity was squandered by the AKP government. The much-needed institutional and productivity-enhancing reforms were ignored, many of the first generation reforms successfully undertaken earlier were reverted and hence this consumption-driven, economic model dependent on foreign funds has reached its structural limits.

Over the past 14 years, the government has chosen to turn the availability of foreign finances into a consumption-driven current account deficit to sustain and further strengthen its patronage-based political model. Hence it is no surprise that over this time period per capita GDP has stagnated in lira terms and declined in US dollars.

*“One has to underline that being stuck in the middle-income trap is the outcome of Turkey’s structural problems, and is not an exogenous event.”*

is characterized by words, not actions. This leads to a very critical policy vulnerability, namely a policy framework that is based on populism, lacking a comprehensive perspective, and one where reform fatigue builds up due to unfulfilled promises labeled as packages. This results in the erosion of credibility. In short, as the AKP delays the much-needed structural reforms, Turkey’s dependence on foreign funds deepens, making it that much more difficult to attract these much needed foreign funds.

The composition of foreign funds is also a contributing factor to the vulnerabilities. The share of portfolio flows, net errors, and omissions in foreign funds is very high. The most recent data from 2016, covering January through May, shows that a total of 7.3 billion dollars of portfolio flows and 2.6 billion dollars of net errors and omissions finance were close to 75 percent of the 13.7 billion dollars of current account deficit. The share of foreign direct investment (FDI) is very low, and at times even negative. Foreign firms are hesitant to invest directly in the Turkish economy. Furthermore, Turkish firms are becoming reluctant to invest in Turkey and are seeking ways to invest abroad to diversify their risk. One has to point out that FDI never became a prominent funding resource for the Turkish current account deficit, except for during periods of heavy privatization and enhanced prospects for EU membership. The erosion of institutional quality and the disregard for the rule of law have both been contributing factors to this downward trend in FDI.

These are all structural problems requiring institutional reforms, not cyclical policies. However, instead of steering the economy towards the much-needed reforms, the ruling party is stubbornly insisting on old habits, thus worsening the scope of the economic black hole. Just as the bureaucracy was decimated with the intentional planting of Gülenists by the AKP government, the same act of decimation once again continues, this time with the purge of anyone suspected of Gülenist sympathies and worse, by the removal of any nonconformist civil servant. The quality of institutions has been eroding for some years but has now reached breakneck speed.

The insistence on the long-established non-merit based system of the AKP continues to inhibit administrative capacity. The government has lost the ability to do much that is useful, even if it wanted to.

These vulnerabilities are an outcome of Turkey’s deeper structural problems. The main structural issue at the core of these problems is the quality of Turkey’s human capital and institutions. These structural problems manifest themselves in what are called “traps,” namely the middle-income trap. One has to underline that being stuck in the middle-income trap is the outcome of Turkey’s structural problems, and is not an exogenous event. An institutional structure that is the backbone of the crony capitalist system alongside the mediocre human capital trap Turkey is stuck in leads to a low value-added production structure, which manifests itself in a “medium-technology trap.” Low value-added production generates an income level that results in Turkey being stuck in the “middle-income trap.”

*“The primary elements of productivity-enhancing reforms should include education reform, technology reform, and a change in the investment-incentive framework.”*

The middle-income trap is evident in the drop in Turkish GDP per capita below 10 thousand dollars, a level it has stagnated at since 2008. This is due to the products manufactured in Turkey. The medium-technology trap is evident in the very low share of hi-tech products in Turkey’s export basket. The share of hi-tech products in Turkey’s manufacturing exports is as low as 3.1 percent, a drop of 2.5 percentage points since 2002. 2012 Organisation for Economic Cooperation and Development (OECD) data on creative problem-solving skills provides stark evidence; the share of students in Turkey who are top performers in exploring a complex problem is two percent – very low compared to the OECD average of 11 percent. According to the most recent PISA results that included 63 countries, Turkey ranks 40th in reading, 43rd in science, and 42nd in mathematic skills.

#### ***Four-Pillar Economic Reform Agenda***

Not all is lost. Our obvious problems, in a sense, present low-hanging policy fruits. Turkey can get out of all these traps with a four-pillar economic reform agenda that is complemented with a new political perspective.

This four-pillar reform agenda consists of the following: (1) an institutional overhaul

to recover from the middle-income trap; (2) a productivity-enhancing reform agenda to recover from the mediocre human capital trap and the medium-technology trap; (3) welfare state reform to eliminate inequalities; (4) a sustainability agenda that ensures a genuine long-term development perspective.

The institutional overhaul must address three main issues. The first and foremost is democracy and freedom, the second is establishing the rule of law and finally, redrafting the public procurement law/framework. Democracy and freedom are prerequisites for building inclusive political institutions that will lead to inclusive economic outcomes. The rule of law will ensure that markets are regulated and supervised efficiently, restoring a sense of equity and fairness among all economic actors. The public procurement law has to be redrafted, mainly to ensure that it is not politically abused as a means of exacerbating the current rent-seeking economic system. It is the public procurement framework and mindset that has to change. The reader should be reminded that the public procurement law has been changed on average once a month over the past 14 years of AKP rule.

Productivity-enhancing reforms are necessary to overcome the main structural bottlenecks. The anti-intellectualism that is building up in the aftermath of the coup attempt on July 15th risks pushing Turkey's best educated human capital to the sidelines. The point is that a productivity-enhancing reform package is necessary but not sufficient to overcome the mediocre human capital trap we are stuck in. Unless this reform package is complemented with reforms to basic freedoms, democracy, and the rule of law, brain drain will become a real threat.

The primary elements of productivity-enhancing reforms should include education reform, technology reform, and a change in the investment-incentive framework. The education reform should concentrate on improving quality without foregoing the accessibility of education. The content of education should be driven by the economic needs of the future, encourage creativity, and be based on rational and critical thinking, rather than ideological indoctrination. The technology reform should start by redefining the role of the state, transforming the technology policy framework from an input-driven model to an output-driven one. This requires that the state's role be changed from acting as a pure financier of R&D to one where the state is an integral part of technology production up until the commercialization stage. The investment-incentive reform agenda should change the focus of incentives to the genuine characteristics of investment rather than its geography.

A true welfare state is necessary to rectify the significant social inequalities. Unlike the current welfare state, which has been instrumental in exacerbating the patronage

system and pushing Turkey further down the path of crony capitalism, a welfare state system that is non-partisan and rights-based has to be implemented immediately.

Finally, the fourth pillar of the development agenda has to have a forward-looking perspective mindful of the many generations to come. This is possible with a sustainability agenda that does not sacrifice long-term prospects for short-term political gains. This would be a sea change in Turkey, one that is much needed.

### *Concluding Remarks*

However, one cannot expect AKP governments to resolve these issues and implement this alternative and much-needed development agenda, because the AKP's existence as a political entity heavily depends on continuing the current economic rules or more truthfully the "rule-less" governing structure they have established. The AKP's economic approach is no longer a market economy where rules are implemented to foster efficiency and equity, but rather the AKP's rules seek to secure its own political future.

Turkey stands at a crossroads. It needs new politics that will allow for the implementation of the aforementioned four-pillar reform agenda. Turkish politics will either take the high road or cling to its mediocrity. The high road is one where politics solves problems rather than creates them, feeds inclusive institutions (both politically and hence economically) rather than extractive ones, is based on a policy-oriented framework rather than a self-driven political focus, and addresses the needs of the whole of the country and not just those of its own electoral base. A fresh politics that should be, and could be, immediately formulated. This is the historical fork in the road Turkey now faces.